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January 14, 2008

To: Supervisor Yvonne B. Burke, Chair
Supervisor Gloria Molina
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

From: William T Fujioka
Chief Executive Officer

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SACRAMENTO UPDATE

Legislative Analyst's Office Overview of the Governor's FY 2008-09 Proposed Budget

Today, the Legislative Analyst's Office (LAO) released its "Overview of the Governor's Budget. In contrast to last year's LAO overview which criticized the Administration for budget proposals that relied on overly optimistic assumptions, this year's analysis points out that the spending proposals appear to be constructed on solid assumptions about caseload and program requirements. The LAO also notes that the Governor's Proposed Budget contains generally reasonable economic and revenue forecasts, but it has some downside risks due to recent cash flow trends and continuing negative economic reports which indicate weak growth in employment and a fragile housing market.

The LAO indicates that while 10 percent across-the-board reductions have the appeal of fairness, it reflects little effort by the Administration to set priorities and determine which programs provide essential services, or are most critical for the State's future. As a result, the LAO recommends that the Legislature should eliminate or further reduce low priority programs to minimize the impact on higher priority programs.

The Governor's proposed Budget contains minimal on-going revenue increasing proposals, and the LAO notes that the Administration is missing an opportunity to achieve additional budgetary flexibility by not reducing Proposition 98 education

spending further in the current year. This would create additional options in FY 2008-09 even to the extent of eliminating the necessity of suspending the full funding of schools under the Proposition 98 formula. In addition, the LAO recommends that the Legislature identify additional revenue solutions, such as the modification, reduction or elimination of existing tax credits or deductions and the identification of costs that can be appropriately supported by user and/or regulatory fees. The LAO also cautions that the Legislature will have to investigate the impact of delaying payments to schools and local governments.

In its November California Fiscal Outlook, the LAO reported that the FY 2007-08 fiscal conditions had deteriorated since the 2007 Budget Act was signed and that the State would need an estimated \$9.8 billion in solutions to balance the FY 2008-09 Budget. The budget problem was attributed to an estimated \$1.8 billion shortfall in FY 2007-08 and an \$8.0 billion shortfall in FY 2008-09 as a result of the softness in the State economy and lower property tax revenues associated with the slump in the housing market which would increase State K-14 education spending. In contrast to the LAO's November estimates, the Governor's Proposed Budget identified a \$14.5 billion shortfall by the end of FY 2008-08.

In light of the State's current financial situation, the LAO makes a number of important recommendations to the Legislature which, include:

- Focusing on areas where time is of the essence for early decisions to achieve targeted current-year savings, which would help to achieve budget year savings. This would include the capturing of unspent prior year funds; and
- Making tough budget decisions now to allow the State to move closer to bringing its long-term spending and revenue into alignment.

The LAO reviewed the Administration's proposed constitutional amendment entitled, "The Budget Stabilization Act (BSA)", which is not yet in print. In the Administration's view, existing formulas make State spending difficult to control and there is little incentive to increase reserves when State revenues increase. While the LAO supports the Administration's intent to build up budget reserves in good times to help balance the State Budget during bad times, the LAO believes the proposal is flawed in its identification of the problem and the execution of a solution. Specifically, the LAO indicates that the Governor's own budget proves that virtually all aspects of the State Budget can be controlled if policy makers are willing to make tough choices, and that if the Governor considers State formulas a problem area, the simplest solution would be to change the formulas. Instead, according to the LAO, the Administration's approach is to make the state's already complicated budget system even more complex with additional formulas to determine (1) when money is deposited in the new reserve and (2) when the Governor can impose spending reductions. In the LAO's view,

formulas, by their nature, cannot predict all future circumstances, and, as a result, they tend to limit, rather than increase, future policy makers' options to craft budgets.

Finally, the LAO is concerned that the proposed changes represent a serious reduction of the Legislature's authority. Under the State Constitution, only the Legislature can appropriate funds and make mid-year reductions to those appropriations. Under the Administration's proposal, the Governor would have the authority to determine when across-the-board reductions and suspensions of State law would occur.

The LAO will be updating its revenue projections and is scheduled to release its Analysis of the 2008-09 Budget Bill next month.

The "Overview of the Governor's Budget" is available on the LAO's website at: <http://www.lao.ca.gov>.

We will continue to keep you advised.

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MAL:MR:sv

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